

## Equity Finance

Equity Finance can be complicated and these notes act as a guide only, in nearly all cases with this type of investment you need to take professional advice after all you could be giving up a significant share of your business.

When businesses require additional finance for which they are unable to use additional loan or invoice finance, equity finance may be a possible solution. Equity Finance or Venture Capital as it is often called provides financing in return for a proportion of your equity (shares). Venture Capitalists take a higher risk than Banks do in the expectation of receiving higher returns. For your part, you have to decide whether the involvement of a Venture Capital firm or a Business Angel is worth losing part of your business and a degree of control.

### Contents

When is Equity Finance Appropriate?	1
The Drawbacks	2
Types of Finance	
Venture Capital Houses	3
Business Angels	4
Finding the Appropriate Angel	5
The Presentation	6
A Personal Deal	7
The Investment Process	7

*Since Redarch was established in 1995 our team of seasoned business professionals have offered their experience and knowledge in all aspects of business.*

*We work as advisors within your operations with demands on our services being dictated by the growth and development of the business and the individuals therein.*

*Our Service is there to guide and support not to dictate or take control, it is your business and we never forget this.*

*If you are ready to start investing in the future of your business and optimising the returns then call us on 01376 57 37 67.*

## When is Equity Finance Appropriate?

- This type of finance is normally only available for larger amounts of money and although some Venture Capital houses will provide smaller loans these tend to be prohibitively expensive and indeed it is often easier to obtain Venture Capital of a million pounds than that of fifty thousand pounds.
- The investors will expect the possibility of a high return; normally at least double the capital value of their investment in three years
- You will need to have a balanced, experienced and professional management team, with a successful track record.
- You need to show commitment, not just enthusiasm. Often the commitment will be measured in terms of the personal investment the current owners/managers have made in the business both in financial and personal terms.
- All the key personnel must be contractually tied in on mutually agreed terms.
- Existing businesses should have a successful track record, with convincing forward plans and cashflow forecasts. New ventures will need a detailed plan and sound market research as well as a strong product/idea preferably with some intellectual property conferred on it.
- Most Venture Capital firms tend towards providing finance for development and expansion allowing a successful company to achieve the next stage in growth
- Finance is often provided for management buy-outs (MBOs) where the existing managers buy the company they work for and management buy-ins (MBIs) where an external management team buy an existing company.
- Some exceptionally promising start-ups can attract Venture Capital to finance their development and marketing costs, but they will need to put forward a very strong case.
- You must also be able to provide an exit route for the venture capitalists and yourselves. Most Venture Capital firms will want to realise their profits, typically within three to seven years.

The most common exits are:

- A trade sale to another company.
- Refinancing of their investment by another institution.
- A listing of the shares on an exchange, such as PLUS (previously known as OFEX), AIM or the Stock Exchange Main Market.
- Repurchase of the Venture Capital firm's shares by management.
- Even if the Venture Capital firm is not going to exit, it will want to keep this option open

## The Drawbacks

- Venture Capital normally imposes certain constraints.
- You will have to generate the cash needed to make the agreed payments of capital, interest and dividends.
- Specific legally binding covenants will be included in the investment agreement to protect the Venture Capital firm.
- The Venture Capital firm may require a nominated representative on your board, typically as a non-executive director, who may want to provide hands-on management if things are going wrong but will usually only be involved in strategic decisions. (His salary will need to be paid by the business)
- The Venture Capital firm will expect regular information and consultation to check how things are progressing.
- Acquiring Venture Capital involves considerable expense, typically, total costs of ten per cent or more of the amount raised is common for smaller investments, and five per cent for larger amounts.
- You will need professional advice
- You will usually be required to pay the Venture Capital firm's costs.
- Acquiring Venture Capital involves considerable management time.
- The whole process typically takes three to six months, though it can be much faster, and it is not unusual for business performance to decline during this time as management is distracted.
- Investment deals can fail at the last moment, because there is a failure to agree a price or other key terms. This is especially common when several investment firms join together (syndicate) to provide the necessary finance. Similarly irresolvable legal problems can crop up at any time during the negotiations, or trading performance declines substantially during the process of raising investment( often as a result of the time spent on raising the finance) or markets change etc.

## Types of Equity Finance

### Venture Capital Houses

Ordinary shares give the Venture Capital firm ownership of an agreed proportion of the company. The Venture Capital firm's return is made up of a combination of dividends (if any) and the increase in the capital value of the shares.

- Ordinary shares are cheap for the company to finance in the short term and dividends can be zero (unless the investment agreement specifies otherwise) but may be a contractual share of profits.
- Negotiations over the proportion of shareholding that the Venture Capital firm receives for an investment can be long and difficult, as generally, owners value their business and hence the shares more highly than outsiders.
- Preference shares are similar to debt, as they pay a fixed dividend and are repaid on specified dates, but they are unsecured. Unlike debt, preference shares protect you against having to pay out cash while the company is making losses, but they may also have conditions attached to them.
- You are prohibited by law from redeeming (repaying) preference shares or paying dividends on them unless the company has generated sufficient profits (distributable reserves) to do so, although entitlement can be rolled over until adequate profits are made to pay them.
- Debt consists of overdrafts, loans, hire purchase, leasing and other borrowings, which is usually secured against specific assets and may require directors/shareholders personal guarantees
- If the company is unable to pay the capital repayments or the interest on time, the lender can sell those assets and /or invoke the personal guarantees as appropriate. This may cause the company to cease trading.
- Usually you borrow from a bank, rather than from a Venture Capital firm, although some firms can provide loans, leasing and hire purchase as well as equity finance.

#### ***Before Approaching Investors:***

- Determine how much finance you need to raise and what your timescales are, how much other capital do you have access to, could you raise finance by other means?
- What level of capital and interest payments (and preference share dividends) can your cashflow support?
- Prepare a professional business plan that will convince potential investors that your business has good prospects and that you know what you are doing.
- Involve a professional adviser
- You must have evidence to support your financial projections. This includes details of your assumptions and how sensitive your projections are.
- Identify potential investors.

- Contact selected Venture Capital firms - It is most productive — but not essential — to approach them through a professional adviser who has previously worked with the Venture Capital firm.
- Prepare a concise executive summary of your business plan to circulate to them and get confirmation that they have some interest.
- Do they make investments of the amount you seek in your type of business?
- Send them your business plan and arrange an initial meeting.
- Prepare a concise, persuasive presentation.
- You will be in a stronger negotiating position if you can interest more than one Venture Capital firm in investing in your business.

## **Business Angels**

Finance of £25,000 to £750,000 can be surprisingly difficult to obtain. Banks generally require security and most Venture Capital firms are not interested in financing these amounts. Business Angels are wealthy, ‘entrepreneurial’ individuals who provide capital in return for a proportion of your company’s shares. They take a personal risk in the expectation of owning part of a growing and successful business. If considering this type of finance it is very important to choose the right investor and not be unduly influenced by the money they are putting forward, get it wrong and you could lose your business and all the hard work you have put in could be for nothing.

### ***Before you start:***

Carefully consider whether this is the right kind of finance for you and your business and whether your proposal is in line with the following criteria:

- Do you want to raise £25,000 to £750,000 and are willing to sell a share of your business in return for financing, which may mean you relinquish some or all of the control.
- Will raising finance in the form of equity (shares) strengthen your balance sheet.
- Will the Bank (or other lenders) may then be willing to provide additional debt finance with or without the additional equity finance.
- Equity finance of over £250,000 is usually provided through a syndicate, (when several business Angels invest together, or when business Angels co-invest alongside Venture Capital funds) this in turn can cause issues that should be considered before you spend time and money seeking this type of investment.
- Are you willing to develop a personal relationship with a Business Angel(s) as most Business Angels want hands-on involvement?
- What skills do you want the Business Angel to bring to the enterprise other than their capital?

- Can you offer the Business Angel the possibility of a high return? An angel would normally expect a return on capital in the region of twenty to thirty percent per annum compounding over the period of investment. This is usually realised as a capital gain at the end of a three to five year period but could also consist of dividends throughout the investment period.
- Can you demonstrate a strong understanding of your product and market, especially if you are seeking finance for expansion.

If you are a start-up or an early-stage company this does not rule out Business Angels who provide a significant amount of investment in this type of venture, however, your business plan and proposal needs to be very convincing with considerable market research and proof of concept, preferably with orders to back up your ideas.

Do you have an experienced and professional management team, alongside strong product(s) and sales skills?

Can you demonstrate both enthusiasm and commitment, not just in terms of how much money you (and other managers) have invested in the business and how strongly your personal earnings are linked to the success of the business, but also in the effort and time you are willing to commit to the success?

Have you established an exit route for the Business Angel and possibly yourself within an acceptable time frame, this could be in terms of a trade sale (selling your business to another company) or your purchasing the business angel's shares by the company or numerous other routes?

## **Finding the Appropriate Angel**

Many contacts are made informally with personal friends and family often being the first source, then wealthy business contacts and individuals known to your professional advisers or even major suppliers and customers of your business.

Business Angel networking organisation exist and some active business Angels use these services to find out about interesting investment opportunities, although you normally have to provide a credible business plan and financial forecasts as part of the registration process, often letting confidential information into a more public arena. Once you are registered, the organisation passes information on to business Angels, Angels will attend presentation meetings (where you present your business to them much in the format of the "Dragons Den" programme on television) or the network may just send out bulletins and any interested angel will contact you directly on a one to one basis.

The business to business sections of various newspapers include advertisements from investors and from businesses looking for finance, but remember, if you want to advertise your business, the advertisement will have to meet the newspaper's standards.

## The Presentation

You usually do not get much time or space in which to present your business to potential investors. (normally about five minutes is the maximum and two is not unusual) so you need to prepare a professional and convincing, concise presentation which should be delivered with confidence and enthusiasm.

Within the presentation you need to:

- Explain your business to demonstrate that you have a clear understanding of what you are doing.
- Explain what your business does.
- Avoid all jargon and if you have to use abbreviations explain them. Assume your audience knows nothing about your industry or product.
- Explain what the key factors to the success of your business are, emphasising any unique features and benefits.
- Explain how you intend to use the money raised.
- Remember, what you are there for – ‘to raise finance’ and tailor your presentation accordingly.
- Business Angels will be far more interested if you can demonstrate that you have firm, profitable orders from blue chips, have some intellectual property rights and have invested your own money in the business.
- Demonstrate that you are offering a potentially profitable opportunity, highlighting your key financial projections and the progress you have made so far. You need to know both your margins and the amounts of profit or loss you have made
- If you have obtained testimonials or endorsements of substance then mention them.
- It may sound obvious, but it is often overlooked, tell your audience how much money you want to raise and what percentage of your business you are willing to give in return (this may be an initial negotiating position so remain flexible.)
- Know the details and be prepared to answer questions on them. You should have prepared a full business plan even if you are not making it available to potential investors at this stage. You need to be able to justify what you have said and written as it is likely to be checked thoroughly before funds are released.
- Be prepared to answer most questions immediately.

## A Personal Deal!

Investments by business Angels can be comparatively informal and rely on a greater degree of personal chemistry and trust than other forms of financing, but you will still need to negotiate the legal aspects and ensure that you are happy with the relationship.

- Look for a Business Angel whose priorities match your needs. If you only want investment, look for an angel who is looking for financial gain first and does not want to be involved in the day-to-day activities, whereas if you need help, look for an angel with the time and specific skills that you need, even if they had not got the investment.
- Decide whether the Business Angel is someone you could work with by trying to obtain answers to the following questions:
  - What motivates the business angel? What is the angel looking for?
  - What skills does the angel have to offer?
  - What appeals most about your business?
  - What causes the most concern?
  - What key weaknesses does the angel identify?
  - Which aspects of the business does the angel find exciting?
- Check the business angel's credentials; this is particularly important if the angel is using the investment to 'buy a job', treat the angel as you would any other potential employee and look at the CV, evidence of previous success, confirm the angel's track record by contacting previous employers and companies the angel has invested in etc..

## The Investment Process

Once a Venture Capital firm/ Business Angel(s) become interested, negotiations can be long and stressful. Your professional advisers can help you.

Use the initial negotiation to get an indication of how much venture capitalists are prepared to invest, and what they will expect in return. At this stage, everything they say will be subject to further negotiation and due diligence. Try to confirm that the investment terms are likely to be acceptable to you. What requirements the investor may want to impose as an integral part of the deal? Will they want to supply finance in a lump sum or in stages, Venture capitalists say there are six reasons for turning down an approach without even meeting a company:

1. The company is looking for too small an amount.
2. The management does not have a strong enough track record.
3. The business plan is unprofessional.
4. The company's profit forecasts have been 'plucked out of the air.'
5. The company is in an industry they do not invest in.'

6. They have already invested as much as they want to in that type of business.’

- Negotiate which of the Venture Capital firm’s costs you will have to pay, including their professional costs for due diligence and determine that their costs should only be payable in the event the investment is completed.
- Make the lengthy due diligence process (typically one to three months) easier by preparing as much information as possible and arranging easy access to records.
- The Venture Capital firm’s advisers will carry out due diligence to confirm the key details of your business.

In particular:

- Financial details
  - Legal details including any Intellectual Property Rights.
  - Key business factors.
- Ensure that everybody connected with the due diligence process has been thoroughly briefed on the project. The Venture Capital firm may seek to renegotiate if negative factors have been revealed by the due diligence process.
  - Use a solicitor to help draw up and negotiate the main terms of the investment agreement which may include:
    - The terms of the investment, such as how much finance will be provided, in what form and what rights investors will have.
    - Warranties confirming that information which you have provided is true. If the business later fails and it is proved that you gave misleading information, the investor will usually have the right to claim compensation from whoever provided the warranties
    - Indemnities, where you agree to accept liability in certain circumstances. For example, if the company is sued in regard to pre-existing contracts.
    - Service contracts that tie in key members of management and staff.

**N.B. Nothing will be finalised until the agreement is signed. In particular, the final terms may not be negotiated until the last minute when you are desperate to complete the deal.**

***N.B. Redarch always use ‘Plain English’ developing Real Growth and Optimising Potential, keeping things simple, knowing that your success is ours also.***